REBUTTAL TESTIMONY

OF

CARLETTE L. WALKER

ON BEHALF OF

SOUTH CAROLINA ELECTRIC & GAS COMPANY

DOCKET NO. 2004-178-E

Q. ARE YOU THE SAME CARLETTE WALKER WHO HAS PREVIOUSLY PROVIDED TESTIMONY IN THIS DOCKET?

A. Yes.

Q. PLEASE DESCRIBE THE SCOPE OF THE REBUTTAL TESTIMONY YOU ARE PRESENTING.

A. My rebuttal testimony responds to certain accounting issues raised in the reply testimony filed by Consumer Advocate Witness Watkins, Navy Witness Smith, and Staff Witness Scott.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony is organized according to the sequence of accounting and pro forma adjustments as contained in the Application and my direct testimony. However, as the Commission is aware, the Commission Staff and the Company have entered into a stipulation. Under the stipulation, the Company and the Staff have agreed, in the spirit of compromise, to accept a number of proposed adjustments which, but for the stipulation, one or the other party would dispute.

In my testimony, I will respond to those Staff adjustments, which apart from the stipulation, the Company would dispute. If the Commission accepts the stipulation, however, these issues will be resolved as set forth in the stipulation, and my testimony about them can be considered moot.

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Q. PLEASE DESCRIBE THE ADJUSTMENTS.

A. **<u>Adjustment No. 1, Annualize NCEMC Contracts:</u>** SCE&G accepts the Staff adjustment related to gross receipts tax associated with the projected revenue from the contracts between SCE&G and the North Carolina Electric Membership Corporation (“NCEMC”).

The Consumer Advocate’s witness Mr. Watkins proposes that the Commission adopt an alternative calculation of energy revenue associated with the 250 MW NCEMC contract. His proposed calculation assumes that positive margins are earned on energy sales (as distinct from capacity payments) on an ongoing basis under the contract. As my earlier testimony states, the Company has structured the 250 MW contract so that over time it will result in a matching of energy expenses and revenue, and no net margin revenue will be realized. Results may vary in individual months based on weather and dispatch patterns but over time those variations are expected to net out to zero.

During the initial months in which the 250 MW contract was in force, there have been periods when the energy component of the contract has produced net revenue (January-March, $1.005 million) and periods when it has produced net losses (April-May, -$737,033). The net gains or losses in these months are not an indication of any trend but are the result of the contract being in force only for a relatively few months. Energy revenues and expenses are still expected to balance to zero or very close to it over time, and there is no basis to assume or project that any additional net gain or loss on energy sales will be generated under this contract.

As presented in my direct testimony, the pro forma adjustment contained in the Application recognizes for rate making purposes the actual net energy revenue realized during the period January-May 2004, i.e., $310,668, and does not recognize revenue related to future months based on the expectation that revenues will balance to zero over those months. In the Application, the Company proposed recognizing the results for January to May 2004, i.e., $310,668, although we believe that this adjustment overstates net energy margins from this contract over time. By contrast, Mr. Watkins' proposal to annualize the net margin experienced in the initial months compounds the atypical results experienced during that time, overstates by a large margin the expected results in the future, and assumes that additional energy revenues will be earned in months when there is no basis for such an assumption.

In addition, the Commission should note that in recent months, the margin revenue from the related 100 MW NCEMC contract has dropped substantially below the level on which the pro forma adjustment was based. If the Commission adopts Mr. Watkins' suggestion that it should update projected revenues based on either contract, it should update both to the most current data. Based on actual revenue through August and updated forecasts based on the additional historical experience gained during the period, the pro forma revenue related to the 100 MW contract should be reduced from the $6.8 million contained in the initial pro forma adjustment to the updated projection of $5.8 million. The result would be a net decrease in revenue from the two contracts of $674,510, which would result in an increase in the rate request by that amount.

Q. MR. WATKINS STATES IN HIS TESTIMONY THAT SCE&G HAS TREATED THE NCEMC CONTRACTS AS CONFIDENTIAL AND HAS NOT PROVIDED THEM IN DISCOVERY. IS THAT CORRECT?

A. Mr. Watkins is mistaken. In response to discovery from Columbia Energy, LLC, the Company stated that the NCEMC contracts contained competitively sensitive information which it would disclose to any parties who were not competitors of SCE&G (as distinct from Columbia Energy, LLC) if they would agree to sign confidentiality agreements. No party other than the Commission Staff and Columbia Energy, LLC has sought disclosure of these contracts pursuant to a confidentiality agreement.

Adjustment No. 2, Amortize Unrecovered Fuel Component of Purchased Power. The Company notes that Staff supports its proposal to amortize these deferred purchased power costs over 3 years. The Consumer Advocate's witness, however, proposes a 5 year amortization. I believe that the 3 year amortization is more reasonable.

As a general principle, when dealing with costs that have accrued incrementally over time, it is preferable to choose amortization periods that reasonably correspond to the accumulation period. In this case, the costs in question accumulated over a two year period. We believe that it would not be reasonable to extend the collection period to five years when the accumulation period was only 2 years. Three years is a more reasonable period because it more closely matches the accumulation period and yet is long enough to spread the impact of the cost in a logical way.

Adjustment No. 6, Selective Catalytic Reactors O&M (Ammonia) –The Staff proposes to reduce the adjustment related to the ammonia expenses associated with the Company's selective catalytic reactors recently placed in service at the Williams and Wateree plants. The first "ozone season" for these plants occurred after the close of the test year. Properly annualizing the Company's experience during the initial months of plant operations, and reflecting current ammonia prices, results in the adjustment as proposed by the Company. This issue would be resolved by acceptance of the stipulation.

Adjustment No. 8c, Health Care Related Adjustments. Mr. Watkins suggests that in making the adjustment for current health care costs, the Commission should rely on Department of Labor figures for health care cost inflation rather than on an annualization of SCE&G's most recent actual experience. In response to Mr. Watkins' suggestion, we have recomputed the annualization amount by updating it to reflect actual costs through August. The actual experience for the January-August period is fully in line with experience during the January-March period. Annualizing January-March resulted in an annual health care expense of $30,161,988. Annualizing January-August results in an increase in total health care expense to $30,182,204 million, or an increase of $20,216. The actual numbers for the first 8 months of the year substantiate fully the Company's proposed pro forma heath care cost adjustment which should be adopted.

Adjustment No. 9, Adjust Long-term Disability Amortization. The Navy's witness Mr. Smith testified that there is no need to amortize the amounts set forth in relation to the long-term disability amortization adjustment. He assumes that the deferred asset and the associated liability for payment of future benefits will be written off simultaneously creating no impact to the income statement.

Mr. Smith, however, ignores the fact that the deferred asset can be amortized only as amounts are collected through rates. As a result, unless the amortization is allowed, there is no means for the deferred asset to be reduced.

Mr. Smith also seems to believe that there is a requirement that the Commission have issued an accounting order before the Company could defer these amounts on its books. This deferral was made with the understanding that the Company would seek approval for the deferral and the amortization in this proceeding, as in fact it is doing. The test for recognizing such a deferral before an order is issued is well established in accounting practice. The test is whether the deferral is consistent with past Commission practices and policies, which this deferral and amortization clearly is. For example, the proposal is fully consistent with the Commission's treatment of the transition obligation associated with the adoption of FAS 106, which was granted in 1993 in Order No. 93-465.

Finally, Mr. Smith questions why these amounts are being recognized at this time. An analogous amount would have been recognized when FAS 112 was effective but the liabilities were reviewed and deemed immaterial at that time. The passage of the Sarbanes-Oxley Act has resulted a stricter application of accounting standards and a much lower threshold of materiality as applied by management and the Company's external auditors. The recognition does not reflect a change in the amount of the liability. Instead, it means that the Company has decided it must accrue these amounts in a forward looking manner, as required by current Generally Accepted Accounting

Principles, rather than recognizing them as expenses on a 'pay-as-you-go' basis, as was proper when the amounts were deemed to be immaterial. The resulting liabilities have now been recognized on the Company's balance sheet.

Mr. Smith further indicates that he believes that these expenses are related to past periods. To the contrary, these expenses relate to the future payments owed to employees who qualify for benefits from this program today. On an annual basis, our outside compensation consultants value these future obligations using demographic data concerning current plan beneficiaries. They represent expenses that are a normal, on-going cost of business to SCE&G. Recognizing them does not involve recognizing any past expense.

The Staff witness has proposed a nine year amortization period (rather than the five-year period proposed by the Company) to reflect the average period over which benefits are to be paid to current plan beneficiaries. Under the stipulation, the Company would agree with this approach and the resulting reduction in annual amortization.

Adjustment No. 13c, Recognize NERC Related Property Additions. Messrs. Watkins and Smith object to the adjustment to increase O&M expenses and rate base for the cost the Company will incur to comply with the new North American Electric Reliability Council ("NERC") standards. In response to the blackouts recently experienced in the Midwestern and Northeastern United States, NERC has established new mandatory operating standards that will go into effect in 2005. To comply with these standards, SCE&G is in the process of hiring employees to perform the newly added reliability monitoring and coordination functions and is purchasing computer hardware and software to support these functions.

These costs are known costs of complying with mandatory NERC requirements. The new employees will be hired --and the new computer hardware and software will be purchased, installed and configured-- before rates approved in this proceeding go into effect. All these activities must be completed to support the January 2005 scheduled training of the new personnel on the new reliability systems. These costs are fully measurable in that the number of new employees and their compensation have been established. In fact, as of late October, the jobs have been posted, the interviews have been conducted and the Company is in the process of extending binding offers. Software is being purchased and suppliers have quoted prices for all required hardware.

Adjustment No. 17a, Jasper Generation Project O & M Adjustment. --The Commission Staff and the Company agree that an adjustment is required to reflect the O&M expenses related to the Jasper Plant. The Company prepared its pro forma adjustment based on detailed staffing, maintenance plans and other fixed cost requirements. The Staff has proposed a reduction in the adjustment based on an annualization of the June-August period for actual O&M. The Company does not believe that these months are indicative of the operating and maintenance expenses that will be experienced going forward given the atypical nature of costs during the initial months of start up. Part of the reason for the disparity is that employees at the plant continue to work on capital related activities and projects during the start-up period. The Company has reviewed the actual operating results, and adjusting for start-up related capital activities, our initial estimates have been fully confirmed. The Company's pro forma adjustment is correct as proposed.

Adjustment No. 17b, Jasper Generation Project Fixed Pipeline Capacity Charges Adjustment. –Mr. Watkins asserts that the Jasper fixed pipeline capacity charges should be excluded from base rates and recovered through the fuel clause until matters relating to these costs are resolved under an open docket before this Commission.

The Commission has considered arguments concerning the Jasper fixed capacity charges in the Company's annual fuel clause hearing in Docket No. 2004-2-E, and approved them. However, should the Commission in any way revise its decision concerning the recovery of any part of these costs, the effect of this decision would be reflected immediately in the Company's fuel clause calculations and customers would get the full benefit of that decision immediately.

Q: PLEASE EXPLAIN.

A. The Company has proposed to transfer $910,167 per month, or $10,922,000 per year, in fixed gas supply costs to base rates using the same methodology that the Commission authorized in Order No. 2003-38 related to the repowered Urquhart units. Under this methodology, all actual fuel costs including the actual Jasper fixed gas supply costs are included in the fuel clause calculations. The adjustment would be reflected by deducting $910,167 per month from the fuel calculation.

The amount of the deduction would not change even if the Commission were to reduce the allowable amount of fixed Jasper costs properly included in the fuel clause Accordingly, any future decision reducing the amount of the fixed charges allowed in the fuel calculation would result in a one-for-one reduction in fuel costs to customers as a result of this netting mechanism.

Adjustment No. 19, Adjust Fossil Fuel Inventory. Messrs. Watkins and Smith object to the adjustment to increase the value of the Company's fuel inventory to reflect current market prices and normal inventory levels, as discussed by Company Witness Lorick. To ascertain the reasonableness of this inventory level, we have computed the average inventory for the years 1999-2003. The five-year average inventory was 733,167 tons. The pro forma adjustment was based on a target inventory level of 708,333 tons, which is 24,834 tons less than the actual 5 year average. The actual test year inventory, of 524,106 tons, is clearly atypical for the reasons Mr. Lorick has stated in his testimony. If the Commission is unwilling to use the Company's target inventory level for this adjustment, then the five-year actual level should be used.

Messrs. Watkins and Smith object to using current coal prices in making the inventory valuation. The fact is, however, that the Company's coal inventory turns over on a regular basis. When the rates established in this case go into effect, that coal inventory will reflect current and not historical prices. The Company has valued its coal inventory based on the actual prices contained in its existing long-term contracts with coal producers. These contracts represent actual, known prices, not projections. In as much as the Company also purchases coal from the short term market, the remaining quantity of coal is valued based on the future strip price, which is the price at which spot coal could be purchased today for delivery in future months. These prices are fully known and measurable based on actual prices for future delivery. Furthermore, we have reviewed actual coal purchase prices for August and September. The actual prices for those months were on average 36 cents per ton above the prices on which the pro forma was based.

<u>Adjustment No. 21, Working Cash.</u> Mr. Watkins has requested that this Commission direct SCE&G to perform a lead-lag study in its next rate case.

There is a long history supporting use of the one-eighth formula before this Commission. On November 13, 1974, this Commission issued a directive that requires the inclusion of working capital in rate base be based on the accepted formula of one-eighth of Operating and Maintenance Expense ("O&M") less Purchased Power Expense.

In Order No. 84-406-E/G, dated October 8, 1984, the Commission ordered the Company to compute its cash working capital using fully developed lead-lag studies. The reason for this departure from the 1974 directive was "to provide the Commission with the opportunity to review an alternative means of computing working capital." (Order No. 84-406 E/G at p. 2). The results of that experiment were reviewed in the Commission's 1987 rate order pertaining to SCE&G.

> *The record of this proceeding indicates that the lead-lag study performed by SCE&G and submitted in response to the Commission Staff's Data Request approximates substantially the traditionally accepted formula approach in providing a reasonable measure of SCE&G's cash working capital requirements. We agree with SCE&G's witness Umbaugh that the expense and effort to prepare such a study does not justify its utilization for ratemaking purposes.*

Order No. 89-588 (p.39).

In 1993, the Commission reaffirmed this conclusion:

> [*T*]*he one eighth formula is a proper means to determine cash working capital. One reason is practicality. The lead-lag study is extremely complex and expensive. A utility company, like SCE&G, generates*

> *millions of bills for services each year and pays thousands of bills from suppliers. If the Commission were to order lead-lag studies, SCE&G's customers would ultimately pay the cost of them. Moreover, the outcome of the studies is very much dependent on the assumptions in labeling and tracking expenditures. . . .[U]tility companies are uniquely well suited for application of a standard formula for cash-working capital purposes.*

Order 93-465 at pp. 36-37, June 7, 1993.

The Commission reaffirmed this conclusion in SCE&G's 1995 and 2003 rate proceedings over objections of the Consumer Advocate that lead-lag studies should be required. Order 96-15, dated January 9, 1996 at pp. 25-26; Order 2003-38, dated January 31, 2003 at pp. 34-36. In the 2003 SCE&G Electric Rate Case Order, the Commission ruled that "the record provides the Commission with no reliable, credible, or probative evidence on which to conclude that new lead-lag studies would, in fact, produce benefits that outweigh the simplicity, clarity and efficiency gained by continuing to rely on the one-eighth formula." Order No. 2003-38, p. 35.

The justifications for not conducting such studies are equally applicable today as they were in these past cases –they are inconclusive, unnecessary and unjustifiably expensive. SCE&G's customers would ultimately pay the costs for studies that are of little or no practical use. The Company recommends that this Commission continue the adoption of the working capital formula as a means of measuring the cash working capital adjustment.

Q: MRS. WALKER, DO YOU AGREE THAT CASH WORKING CAPITAL SHOULD BE CALCULATED BY APPLYING THE ONE-EIGHTH WORKING CAPITAL FORMULA TO EXPENSES AFTER ACCOUNTING FOR O&M PRO FORMA ADJUSTMENTS?

A. Yes. The cash working capital calculation should be made using the best available information concerning the O&M expenses for which cash working capital will be required. As the Commission is aware, test year O&M expenses are only the starting point for determining the O&M expenses which should be recognized for rate making purposes. Test year expenses only become an accurate reflection of O&M expenses for rate making purposes after pro forma adjustments are made. The Commission makes such adjustments to remove non-allowable expenses and to remove or include expenses due to known and measurable changes that will occur at or before the time rates go into effect.

The allowance for cash working capital should reflect pro forma adjustments. Otherwise, the cash working capital allowance will not accurately reflect the true level of O&M expenses for which cash working capital is required.

Q. WHY HAS IT NOT BEEN THE PRACTICE IN THE PAST TO REFLECT PRO FORMA ADJUSMENTS IN CASH WORKING CAPITAL?

A. There does not appear to be any principled reason in regulatory or rate making policy to support not reflecting pro forma adjustments in the calculation of cash working capital allowances. In fact, witnesses as adverse to the Company as Mr. Watkins adjust the cash work capital for the pro forma adjustments that effect O&M expenses. In addition, the record shows that the Commission previously made such adjustments in past proceedings. See Order 87-1381 dated December 30, 1987.

<u>Adjustment No. 22, Tax Effect of Annualized Interest</u>. --The Consumer Advocate's witness Mr. Watkins has proposed a larger adjustment than the Company has proposed related to the tax effect of annualized interest. The process by which Mr. Watkins annualized interest expense is conceptually correct, and is consistent with the methodology that the Company employed in calculating its pro forma adjustment. However, Mr. Watkins selected a per book interest expense number, contained in the Company's cost of service study, that does not reflect the Company's full interest expense. The number he selected understates the full amount because it includes a deduction for interest expense capitalized on the acquisition of nuclear fuel. The number Mr. Watkins used was $102,559,000. The actual interest expense used in the determination of the Company's income tax for the test year was $117,982,000 on a retail basis and reflects the Company's full interest expense. In addition, it appears that Mr. Watkins used a Federal Income Tax rate of 38.68% instead of the Company's actual Federal Income Tax rate of 35%. The result of using the correct interest expense and the 35% tax rate in this calculation is a reduction of income tax expenses of $185,000 as opposed to Mr. Watkins' calculation of a reduction of $6,641,000.

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Q: MRS. WALKER, DO YOU AGREE WITH THE STAFF PROPOSED REDUCTION TO RATE BASE FOR INTEREST ACCRUED BUT NOT PAID ON CUSTOMER DEPOSITS?

A. No. The Staff has proposed a reduction to rate base based on interest accrued during the test year. The Company does not contest the need for such an adjustment, rather we believe that the basis the Staff has chosen for making this adjustment is improper and overstates the amount of the adjustment.

Interest accrued on customer deposits is subject to refund, and in fact, the Company makes interest refunds to customers on a on-going basis. As a result, the amount accrued during any test year or any other period will overstate the net amount outstanding at any time, because the amount accrued does not reflect the off-setting amount that has been repaid to customers during the period. The appropriate basis for the adjustment should be the balance owed to customers for interest. The outstanding balance of accrued interest on customer deposits held by the Company as of September 30, 2004 is $423,834. This amount represents the appropriate reduction to rate base attributable to these funds. I would note that if the stipulation of settlement with the Staff is approved, this issue will be moot.

Q: PLEASE RESPOND TO THE PROPOSALS OF THE STAFF'S WITNESS AND THE CONSUMER ADVOCATE'S REGARDING INCENTIVE AND OFFICER PAY?

A. Both the Staff Witness Ms. Scott, and the Consumer Advocate's Witness Mr. Watkins propose that the Company not be allowed to recover the full amount of the compensation the Company in fact paid to its officers and employees during the test period. In the stipulation of settlement, the Company has agreed to a compromise proposal to reduce the executive compensation included in rates by $4.2 million. This agreement has been reached in the spirit of compromise. If the stipulation is not accepted by the Commission, the Company would return to its basic position that the full amount of the compensation paid during the test period is a valid, recurring expense of utility operations and should be recovered through rates.

Q: WHY DO YOU BELIEVE THAT THE FULL AMOUNT OF THE COMPENSATION SHOULD BE RECOVERED?

A. The Company's compensation packages for its employees and officers are set annually based on surveys of market compensation in similarly situated companies. Our packages include base salaries, short-term incentives, and long-term incentives. We measure the full package against the market and ensure that the total package, including all elements, is consistent with regional and industry standards. Our target and philosophy is to compensate employees and officers at the mid-point of the market and we are neither the highest or the lowest paying company, all factors considered, in our industry and region. To disallow a substantial part of this package would be to put the Company at risk as far as attracting and retaining skilled and competent personnel and would not allow the Company the opportunity to recover the full amount of its reasonable and prudent costs of providing utility service.

Q: HOW DO YOU RESPOND TO MR. WATKINS' SUGGESTION THAT THERE SHOULD BE A 50-50% SHARING OF INCENTIVE COMPENSATION BETWEEN CUSTOMERS AND SHAREHOLDERS?

A. I have two responses. First, as Mr. Watkins recognizes, incentive pay is something that "can and does come, in part, from increased efficiency, which will benefit ratepayers in the long run." (Watkins' Direct at p. 54, lines 23-24). Earnings are a sign that, among other things, the Company personnel have operated in an efficient and budget conscious manner.

Second, the Commission will set a revenue requirement for the Company in this proceeding that includes its costs of utility operations, its costs of debt capital and its cost of equity capital. If the Commission then disallows part of the Company's compensation expenses based on a "50-50% sharing," the result would be that the Company would not be allowed to recover the full cost of its utility operations but instead would have to recover these costs out of funds intended to cover its costs of debt capital and its cost of equity capital.. There is no other source of funds to cover the costs that Mr. Watkins would disallow.

Q: MRS. WALKER, DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.